Tuesday, February 29, 2000

DO NOT PUBLISH

UNITED STATES BANKRUPTCY COURT NORTHERN DISTRICT OF CALIFORNIA

In re:
Bankruptcy Case
No. 99-3-3580-TC
Chapter 11

ASPEN WEST TORRANCE HOSPITAL, INC.,
a Delaware corporation,
Debtor.
_____/

In re:
Bankruptcy Case
No. 99-3-3581-TC
Chapter 11

ASPEN HEALTHCARE, INC.,
a Delaware corporation,
Defendant.
_____/

MEMORANDUM RE MOTION TO VACATE APPOINTMENT OF COUNSEL FOR DEBTORS AND DIRECT COUNSEL TO DISGORGE FEES

The court held a hearing on February 14, 2000 regarding the motion of the United States Trustee to remove Arter & Hadden as counsel for the Debtors in possession and to require them to disgorge all fees received for these chapter 11 cases. Stephen L. Johnson appeared for the United States Trustee. Michael S. Kogan appeared for Arter & Hadden. Upon due consideration, and for the reasons stated below, I determine the motion to disgorge should be granted.

FACTS

Aspen Healthcare, Inc. (Aspen) and Aspen West Torrance Hospital (West Torrance) each filed chapter 11 petitions on November 5, 1999. The Debtors are both in the business of residential health care and are closely related. West Torrance is the parent of a non-debtor corporation that operates a nursing home in Southern California. Aspen owns all the stock of West Torrance. Arter & Hadden (A&H) was appointed to act as counsel for the debtor in possession in each case.

A&H disclosed the following information in the application for employment that it filed in each of these chapter 11 cases: (1) the amount of the retainer it received for the bankruptcy case; (2) that it had represented the Debtor in general business matters prior to its employment in the bankruptcy case; and (3) that it waived all prepetition claims against the Debtor. A&H did not disclose that shortly before the petition date it had received the following payments from Aspen for legal services unrelated to the bankruptcy cases.

Amount	**Date**	**Days Before Petition**
$ 41,236	June 23, 1999	135
$ 42,321	August 17, 1999	81
$ 25,000	September 20, 1990	46
$ 12,000	October 12, 1999	24
$ 9,025	October 12, 1999	24

Two of these prepetition payments to A&H were disclosed in Aspen's statement of financial affairs. Question #3 asks the debtor to list all payments to creditors made within 90 days before the petition date. The answer to this question in the Aspen case included the following information.

Vendor	**Doc. Number**	**Doc. Date**	**Post Date**	**Amt Paid**	**Owe**

ARTHADD	6717	06/23/1999	06/23/1999	$41,235.79	
ARTHADD	7161	08/17/1999	08/17/1999	$42,327.31	
				$83,563.10	**$42,387.61**

DISCUSSION

The Bankruptcy Code and the Federal Rules of Bankruptcy Procedure create numerous safeguards to ensure that attorneys who represent a debtor in possession act in the best interests of the estate. Section 327(a) of the Code provides that an attorney who represents the estate must be disinterested and may not hold or represent an interest that is adverse to the estate. Bankruptcy Rule 2014(a) requires that an attorney applying to represent the estate must disclose inter alia all "connections with the debtor."

The Ninth Circuit has interpreted these requirements strictly. The court stated "All facts that may be pertinent to a court's determination of whether an attorney is disinterested or holds an adverse interest to the estate must be disclosed." In re Park Helena Corp., 63 F.3d 877, 882 (9th Cir. 1995)(emphasis in original)(citation omitted). The court also stated that the disclosure of such facts must be "complete," "candid," "direct and comprehensive," and "lay bare all dealings." Id. at 881. "Coy, or incomplete disclosures . . . are not sufficient." Id. (Citation omitted). Moreover, "[n]egligent or inadvertent omissions 'do not vitiate the failure to disclose'." Id. (Citation omitted).

At minimum, A&H should have disclosed in its applications for employment the payments it received from Aspen within 90 days before the petition date. Such payments may be preferences that could be recovered by the estate. 11 U.S.C. § 547. Having received such payments, A&H holds an interest (retaining the payments) that is adverse to the interest of the estate (recovering those payments). Although such payments would not be recoverable if made in the ordinary course of business, 11 U.S.C. §547(c)(2), A&H's response to the motion does not establish that this defense is applicable. Moreover, whether or not the defense is available, the payments were facts "pertinent to a court's determination of whether an attorney is disinterested." Park Helena, 63 F.3d at 882 (citation omitted).

A&H argues that it made adequate disclosure because at least one of the payments was listed in Aspen's statement of financial affairs. This argument is unpersuasive. Rule 2014(a) requires that all pertinent facts be disclosed **in the application for employment**. The bankruptcy court should not be required to sift through the schedules and statement of financial affairs to find facts regarding potential adverse interests. Disclosure through the statement of financial affairs is not the candid, direct, and comprehensive disclosure that Park Helena requires.

A&H also argues that the failure to disclose the payments was inadvertent and does not warrant disgorgement of fees. This argument is also unpersuasive. Park Helena does not bar disgorgement even if the failure to disclose is merely negligent or inadvertent. Park Helena, 63 F.3d at 882. More important, I find that the A&H willfully failed to disclose the payments in question. In so finding, I rely upon the following subsidiary findings of fact. First, A&H

represented in its application for employment that it has "vast experience in insolvency and reorganization cases." Second, published decisions make clear that applicants should disclose potentially preferential payments. See In re Flying E Ranch Co., 81 B.R. 633, 635 (Bankr. D. Colo. 1988). Third, the amount of the payments was substantial ($88,352 within 90 days of the petition). Fourth, A&H addressed the issue of prior legal services in a way that appears intended to convince the court that it had addressed the relevant issues and that no problems existed. A&H stated that it had previously performed legal services for the Debtors and that it had waived all prepetition claims for such services. This statement gives the impression that A&H had not received payment on its prepetition claims shortly before the bankruptcy filings. Taken together, the fact that the A&H application addressed prepetition work, that its statements regarding such work create the impression that A&H had not recently received payments for such work, and that A&H clearly knew that the payments were relevant to their eligibility for appointment leave me firmly convinced that A&H deliberately chose not to disclose those payments candidly, directly, and comprehensively.

I determine that A&H should be required to disgorge all fees received for work in both bankruptcy cases. Although all the prepetition payments in question were paid by Aspen, it is appro-priate to impose the same remedy in the West Torrance case. The two cases are closely interrelated. West Torrance is a wholly owned subsidiary of Aspen. The applications for employment state that the cases should be substantively consolidated. The retainer for the West Torrance case was paid by Aspen. Most important, A&H's lack of candor suggests that it should not represent either estate.

CONCLUSION

A&H shall by March 15, 2000 turnover to the chapter 11 trustee appointed in the Aspen case the entire amount of the retainers received, and any other payments received for services in the Aspen and West Torrance chapter 11 cases.[(1)]

Dated: _____

_____

Thomas E. Carlson

United States Bankruptcy Judge

1. This decision does not address whether the prepetition payments A&H received for work unrelated to these bankruptcy cases are preferences that can be recovered by the estate. It is not necessary to remove A&H as counsel for the Debtors in possession, because the court has ordered the appointment of a chapter 11 trustee in each of these cases.